Internal Revenue Service

memorandum

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Br5:MGillmarten

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to: Larry Vining, IE, Dallas District

from: Barbara Felker, Senior Technical Reviewer, Branch 5
Associate Chief Counsel (International)

subject: [redacted] and §954(c)(3)(B) of the 1954 Code

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This memorandum is in response to your request for assistance in interpreting the term "unearned premiums or reserves" in §954(c)(3)(B) of the 1954 Code and §1.954A-2(d)(3) of the regulations, and in determining whether certain assets are includable in the term "reserve assets" in §1.954A-2(d)(3)(iii).

Your question arises in the context of an examination of [redacted] and its offshore captive. The Service has argued, and continues to argue, that payments received by a captive from a related party do not qualify as insurance premium income. Therefore, to the extent the captive does not have sufficient unrelated premium income to meet the definition of an insurance company under subchapter L, it cannot qualify as an insurance company eligible for the beneficial accounting provisions under subchapter L. Despite continued confidence in this position, the Service is also exploring alternative adjustments for captives, assuming the Service does not prevail on the initial argument and a court concludes the captive qualifies as an insurance company.

[redacted] argues that its captive is an insurance company and that income earned on its unearned premium reserve, unpaid loss account, and incurred but not reported (IBNR) loss account are excludable from subpart F income under §954(c)(3)(B) for years prior to 1987. As in effect prior to amendment by the 1986 Tax Reform Act, §954(c)(3)(B) provided that "... interest ... derived from the investments made by an insurance company of its unearned premiums or reserves ordinary and necessary for the proper conduct of its insurance business" was excluded from foreign personal holding company income.

You suggest that the term "unearned premiums or reserves" is meant to create an election so that the taxpayer must choose to exclude either income earned on unearned premiums or income earned on other "reserves," but may not exclude income earned on both. While we agree that the statute and regulations could be more clearly drafted, we do not agree with this interpretation of the statute. There is no indication in the statute that Congress intended to create an election, and, particularly, there is no mechanism for making such an election. Therefore, we think the exclusion, to the extent available to insurance companies, applies to income earned on both unearned premiums and other "reserves."

The question remains, then, whether Congress intended to include unpaid loss accounts and IBNR accounts within the general term "reserves ordinary and necessary for the . . . conduct of . . . business."

Section 954(c)(3)(B) was enacted based on the view that some industries (e.g., financial services and insurance) earn passive income in the ordinary course of their business and that those amounts should, therefore, not be included in foreign personal holding company income. There is nothing in the statute, regulations, or legislative history to subpart F to indicate that Congress intended to distinguish between life insurers and property/casualty insurers in this regard. To hold that earnings on life insurance reserves are excludable under §954(c), but that earnings on amounts held by property/casualty companies on unpaid loss accounts and IBNR accounts are not, would lead to inconsistent treatment of taxpayers that appear to be similarly situated in terms of the policy goals of the statute. It is clear that unpaid loss accounts and IBNR accounts are ordinary and necessary for the conduct of property/casualty insurance business. Further, §1.954A-2(d)(3) provides that a U.S. shareholder of a CFC insurance company may submit evidence of the insurer's experience as proof that a "reserve" is ordinary and necessary; experience being a measure for unpaid loss and IBNR accounts rather than life insurance reserves, this may suggest that the drafters viewed such amounts as equivalent to reserves.

For these reasons our view is that the better reading of §954(c)(3)(B), as in effect for pre-1987 years, is to include property/casualty "reserves" in the term "reserves ordinary and necessary for the proper conduct of its insurance business."

Section 1.954A-2(d)(3)(iii) limits the amount of the exclusion under §954(c)(3)(B) to an amount equal to the eligible investment income multiplied by a fraction. The

numerator of the fraction is the mean of the CFC's unearned premiums or reserves (described above) at the beginning and end of its taxable year. The denominator of the fraction is the mean of the reserve assets held by the CFC at the beginning and end of its taxable year. Section 1.954A-2(d)(3(iii) defines reserve assets as "assets which may give rise to foreign personal holding company income described in §954(c)(1) (without regard to modifications and adjustments under §954(c)(3) and (4))."

Section 954(c)(1) of the 1954 Code referred to the definition of foreign personal holding company income in §553. Section 553 defined foreign personal holding company income to include dividends, interest, royalties, and annuities, gains from the sale or exchange of stock and securities (except dealer transactions), and gains from certain commodity transactions.

[redacted] has a second tier subsidiary (Subsidiary) owned [redacted] percent by [redacted]'s captive. Subsidiary is a finance company. For the years at issue [redacted] reported all the income earned by Subsidiary on its federal income tax return as subpart F income under §951(a). [redacted] argues that because the income earned by Subsidiary is reported by [redacted] under §951(a) and will be excluded from the captive's income under §959 when distributed, the Subsidiary stock held by captive cannot "give rise to foreign personal holding company income" and, therefore, is not a "reserve asset" for purposes of computing the exclusion limitation under §1.954A-2(d)(3)(iii).

We disagree with [redacted]'s interpretation of the law. First, the types of income ordinarily produced by subsidiary stock are dividend income and gain on its sale, both of which constitute foreign personal holding company income as defined in §954(c)(1) and §553(a)(1). Under §959(b), previously taxed amounts will be excluded from the captive's gross income under §951(a) when distributed, but such amounts still constitute a "dividend" within the meaning of §954(c)(1) and §553(a)(1). Cf. §959(d) providing that a distribution excluded from gross income under §959(a) shall not be treated as a dividend. The regulations do not make an exception from the denominator of the limiting fraction for foreign personal holding company income that is previously taxed income, and there is no reason to read such an exception into the regulations. Secondly, even if such an exception were appropriate, Subsidiary could earn non-subpart F income which increases earnings and profits (including subpart F income not treated as such under the high-taxed exception or the de minimis rule). Such earnings and profits could support the distribution of a (non-previously

taxed) dividend to the captive. Therefore, Subsidiary stock is an asset that "may give rise to" foreign personal holding company income and qualifies as a reserve asset includable in the denominator under §1.954A-2(d)(3)(iii).

Taxpayer argues that because the income is previously taxed income under §951(a) by virtue of [redacted] including the income as subpart F income on its federal income tax return, §959 precludes inclusion of that amount in subpart F income of any other corporation in the chain of ownership (as defined in §958). Including the asset in the denominator of the limitation fraction is not the same as including previously taxed income in the captive's taxable income. The Subsidiary stock remains an asset which may give rise to foreign personal holding company income, notwithstanding the fact that some such income may be excluded from captive's taxable income by virtue of §959(b).

In summary, we do not agree that [redacted]'s captive is an insurance company. However, should that issue be conceded as part of the examination or appeals process, an adjustment to [redacted]'s subpart F income is appropriate. The investment income earned on the captive's unearned premium reserve, unpaid loss account, and IBNR account is eligible for exclusion under §954(c)(3)(B) of the 1954 Code, subject to the limitation in §1.954A-2(d)(3)(iii) of the regulations. The numerator of that limitation fraction should contain the mean of the unearned premium reserve, unpaid loss account and IBNR account. The denominator should contain the mean of all reserve assets, including the stock in Subsidiary.

If you have any further questions, please call Mary Gillmarten at FTS 566-6284.

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